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IN THE MATTER OF THE APPLICATION OF DUNCAN RURAL SERVICES CORPORATION FOR A RATE INCREASE	DOCKET NO. G-02528A-05-0314
IN THE MATTER OF THE APPLICATION OF DUNCAN RURAL SERVICES CORPORATION FOR A RATE INCREASE	DOCKET NO. G-02528A-03-0205 **CLOSING BRIEF**

I. INTRODUCTION

Staff agrees that Duncan Rural Services Corporation ("Duncan") needs an increase in rates. Staff supports an increase in the revenue requirement of $147,406 (45.24 percent increase over test year margin revenues). If Staff's recommendations are adopted, Duncan would get an operating margin of $65,665 and an 8.66 percent rate of return on an adjusted original cost rate base of $758,057. Staff's recommendations will provide Duncan with a times interest earned ratio of 3.38 and a debt service coverage ratio of 1.64. But Duncan still takes issue with key portions of Staff's case.

Duncan opposes Staff's recommendations regarding an equity improvement plan. But Duncan's capital structure consists of a negative 42 percent equity ratio. That is unacceptable and must be improved. Staff's recommendation for Duncan to improve its equity ratio by five percent each year provides a reasonable and methodical approach toward a goal that must be achieved if Duncan is ever to get financing other than borrowing from Duncan Valley Electric Cooperative ("DVEC"). Continuing the pattern of Duncan incessantly borrowing from DVEC is not in the public interest for customers of Duncan or DVEC, which is why Staff's plan should be adopted. But Staff's recommendation is moderate and flexible enough to allow Duncan to fund ongoing capital expenditures and still maintain a solid net margin. As explained below, Duncan does not need additional five percent rate increases in 2006 and 2007 because of Staff's equity improvement recommendation. Nor does Duncan need an additional $98,000 in cash, advanced from DVEC and approved as long-term debt, to fund capital expenditures. In fact, approving additional long-term debt worsens Duncan's highly leveraged capital structure.

As to treatment of cash advanced from DVEC to Duncan since Duncan's last rate case, totaling about $502,000, Staff's recommendations are in accord with sound financial principles. On the contrary, Duncan's proposal for approval of $600,000 as long-term debt – including $98,000 not yet advanced – is not appropriate and is premature. Staff recommends that only $330,484 be treated as long-term debt because that was the portion of cash advance used for capital expenditures. For the cash advance that was used for operating expenses ($171,516) Staff recommends treatment of this portion as an equity infusion from DVEC to Duncan.

Tied into these issues is Duncan's request for additional five percent rate increases in 2006 and 2007, beyond the $147,406 revenue increase originally proposed. This means a total revenue increase of $167,705 if the two subsequent five percent increases became effective. Duncan justifies these additional rate hikes by stating that it cannot meet Staff's equity improvement recommendation without them, and because it needs $80,000 a year to finance capital improvements. But as explained below, Duncan misinterprets Staff's equity improvement recommendation and thus its request for additional rate increases is also unnecessary. Duncan will be able to pay for future capital expenditures and improve its capital structure with Staff's recommendations adopted.

Staff's recommendations to zero out the base cost of gas, and move the entire cost of gas into Duncan's Purchase Gas Adjustor ("PGA") enhances customer's ability to understand his or her bills and better track the cost of natural gas and its effect on his or her bills. But Staff opposes Duncan's proposal to apply the $0.10 bandwidth on a monthly basis, allowing a 10-cent change in the adjustor rate each month will increase the volatility in customer bills. Continuing to apply the bandwidth to any PGA rate for the past 12 months and limiting the adjustor rate change to 10 cents over the course of a year better promotes gradualism and overall rate stability while not eliminating price signals to customers.

Staff's rate design proposal factors in gradualism, stability and affordability, but also incorporates the cost of service study as analyzed and modified by Staff. While there are many reasonable ways to design rates, and Duncan's concerns about irrigation customers are legitimate, Staff believes Duncan's proposed rate design impacts residential customers too severely in the winter months. This is why Staff opposes continuing to have separate summer and winter commodity rates. At the same time, Staff's recommendation for separate commodity rates for each customer class also moderates the impact on irrigation customers. The result is that Staff's rate design is fair and equitable to all customer classes and types and does not too severely impact residential or irrigation customers.

II. STAFF'S EQUITY IMPROVEMENT RECOMMENDATION WILL IMPROVE DUNCAN'S FINANCIAL HEALTH

Staff proposes that Duncan improve its capital structure by five percent each year until Duncan has at least thirty percent equity as part of its overall capital structure. During the hearing, Staff detailed its recommendation using a simple example. Staff testified at the evidentiary hearing that the five percent figure is based off of Duncan's total capital at the end of 2005. Staff expected that figure to be lower than it was at the end of the test year (i.e. lower than $363,884).[1] Staff's is also excluding the $330,484 that it is recommending be classified as long-term debt out of the $502,000 advanced from DVEC to Duncan since the last rate case.

Staff's equity improvement recommendation is a moderate one, as shown by the following example. If, hypothetically, Duncan's total capital equaled $300,000, then Staff expects Duncan to contribute $15,000 each year in equity. Even if Duncan's total equity were to be $315,000 in year two for example, Staff only expects an additional $15,000 to be contributed (five percent of the original $300,000 figure). Furthermore, using the above example, if Duncan contributed $20,000 in year one, then Duncan only has to contribute $10,000 in year two to be in compliance, because Duncan would have contributed an average of five percent per year over the two years.[2] The only variance is if Duncan were to receive additional debt financing in a

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[1] Tr. at 119:3-8.

[2] Tr. at 123:1-5; 137:1-11.

particular year. For instance, if, in year two, Duncan received an additional $30,000 in debt financing, then Duncan would be expected to contribute a total of $16,500 for that year ($330,000 times five percent), but only for that year (i.e. in year three the requirement would be back to $15,000 if no additional debt financing were acquired).[3] Furthermore, as detailed below, Staff is recommending that part of DVEC's cash advances to Duncan, $171,516, be treated as an equity infusion. This equity infusion can count toward the five percent per year benchmark, giving additional flexibility and moderation to Duncan in meeting the annual equity improvement target.[4]

Finally, Staff's equity improvement recommendation is not punitive in that there is no automatic punishment that takes effect should the cumulative five percent equity target not be achieved. Rather, Staff is simply recommending that Duncan a rate case should it not achieve that target.[5] In this way, insurance exists that the Company will not take a step back into these precipitous depths as far as capital structure and equity ratio is concerned. The most important thing is to institute a concrete plan toward improving Duncan's financial health, and Staff's recommendation here does that in a reasonable fashion.

III. DUNCAN DOES NOT NEED TWO ADDITIONAL FIVE PERCENT INCREASES APPROVED AT THIS TIME

Because of Staff's equity improvement recommendation, Duncan requested, in its rebuttal and rejoinder testimonies, additional rate relief beyond this case. Specifically, Duncan requests two additional five percent rate increases: one for 2006 and one by January of 2007. But Duncan's request for these additional increases was based on a misunderstanding of Staff's recommendation. Duncan believed that the total capital figure used would include the $330,484 portion of the cash advance from DVEC Staff recommends be treated as long-term debt.[6] But Staff is not recommending this $330,484 figure be factored into the calculation.[7] The total

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[3] Tr. at 121:9 – 122:7.

[4] Tr. at 137:8-11.

[5] Tr. at 123:19-22.

[6] See Rejoinder Testimony of Jack Shilling, Exhibit A-8, at 5:10-23.

[7] Tr. at 119:25 – 120:4.

capital figure Staff recommends be used in the calculation, capital at the end of 2005, will be likely lower than it was at the end of the test year.[8] So Duncan was under the mistaken belief that would be mandated to contribute an additional $16,524 above what Staff is recommending. With this clarification, Duncan's basis for requesting additional rate increases disappears. The additional rate increases are not needed for Duncan to meet the five percent equity-improvement target annually. But should Duncan feel that additional rate relief is necessary in the future, then it should file a new application at that time. But granting two additional five percent increases now is not justified by the record in this case.

At test year's end, Duncan had a capital structure of 142.07 percent debt and negative 42.07 percent equity.[9] This is not an acceptable capital structure for any utility. Clearly, Duncan must start improving its capital structure now and Staff's recommendation is a moderate but consistent and significant means towards achieving that end. Staff's recommendation for a mandatory improvement to Duncan's capital structure is in the public interest and provides Duncan a path toward financial health, where it could ultimately obtain financing from other sources. Continuing to borrow funds from DVEC, the only source where it currently can get financing, is not beneficial to Duncan or DVEC. The bottom line is that the long-term strength depends on Duncan boosting the amount of equity in its capital structure. Staff's recommendations achieve this aim, but do not ignore Duncan's current financial situation. These recommendations are reasonable, in the public interest, and should be adopted.

IV. DUNCAN SHOULD RECEIVE APPROVAL OF $330,484 AS LONG-TERM DEBT, BUT NOT $600,000; $171,516 OF DUNCAN'S REQUEST SHOULD BE TREATED AS AN INFUSION OF EQUITY

Duncan's updated request for additional rate relief includes a request for approval of $600,000 in debt financing for cash advances from DVEC. Of the $600,000, $502,000 covers present advances, while $98,000 covers future advances from DVEC.[10] But Staff believes only $330,484 out of the $502,000 should be treated as long-term debt financing. The remaining

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[8] Tr. at 119:3-8.

[9] See Direct Testimony of Daniel Zivan, Exhibit S-3, at 25:8-11.

[10] See Zivan Surebuttal at 2:8-11.

amount of the cash advanced, $171,516, should be treated as an equity infusion from DVEC. The additional $98,000 should not be approved at this time because it is unnecessary and would add to an already highly leveraged capital structure.

Staff's audit revealed that $330,484 out of the $502,000 advanced from DVEC was used for capital expenditures.[11] It is therefore appropriate to classify this amount as long-term debt. But the remaining amount, $171,516, covered operating expenses. Consequently, it is inappropriate to treat funds for operating expenses as long-term debt because a cost shift occurs that results in customers in later periods paying for benefits solely received by customers in earlier periods.[12] Even with a declining customer base, as Duncan alleges it is experiencing, remaining customers are unfairly burdened with operating expenses for past years.[13] Instead of treating this figure as debt, but because the cash was advanced to Duncan from DVEC, Staff recommends that this $171,516 amount be treated as an equity infusion. Also, this recommendation, aside from being in accordance with sound financial principles, also helps Duncan meet the annual five-percent-equity-improvement target.[14] So, classifying $171,516 as an equity infusion immediately boosts Duncan's capital structure, improving its health and putting it on the road to improved robustness.

As to the additional $98,000 Duncan requests, Staff believes that it is a precarious path to approve any additional long-term debt over what is absolutely necessary at this time. Staff's equity improvement recommendation, as clarified in the evidentiary hearing, does not mandate approving an additional $98,000 in long-term-debt financing, because Duncan can fund an additional $80,000 in capital improvements annually, and meet the five-percent-equity target annually. Furthermore, approving additional debt exacerbates Duncan's highly leveraged capital structure. So Staff opposes additional cash advances from DVEC and classifying those as long-

[11] Zivan Direct at 23:10-13.
[12] Id at 24:15-19.
[13] Zivan Surebuttal at 3:15-19.
[14] Tr. at 124:17-22.

term debt in this case. Should Duncan feel the need to seek future cash advances, it has the option to file for Commission approval at a later date.

Intertwined with this topic is the issue of interest expense. Duncan was proposing it receive \$39,187, which includes \$14,087 of interest expense on current loans plus \$25,100 of interest for the \$502,000 cash advances classified as long-term debt at a five percent rate.[15] But as of September 2, 2005, the actual interest rate for a 270-Day-Fixed-Rate Note, the applicable rate for this kind of long-term debt, was only at 2.725 percent.[16] While this rate may have changed subsequently, Staff is only recommending treatment of \$330,484 as long-term debt for the reasons described above. So, since 2.725 percent of \$330,484 equals \$9,006, Staff is recommending a total interest expense of \$23,093 (\$9,006 plus \$14,087).[17]

Finally, the pattern of DVEC issuing cash advances to Duncan must be closely monitored and it cannot continue as it has. Staff's recommendations are with regards to cash advances already made by DVEC to Duncan. Commission approval is necessary for any future cash advances. Furthermore, Duncan's financial condition will not be improved, and will likely worsen, if this pattern is to continue unfettered.[18]

V. STAFF'S RECOMMENDATION FOR A \$70,000 LINE OF CREDIT ADDRESSES DUNCAN'S CONCERNS ABOUT CASH FLOWS WITH RISING NATURAL GAS COSTS

Staff acknowledges that Duncan has a legitimate concern about cash flow, especially if the under-collected PGA bank balance continues to grow. Staff proposes the \$70,000 line of credit to address this concern. While the details of the line of credit may be complex, the basic idea is to allow Duncan to borrow up to \$70,000 to address any increase in the under-collected bank balance from the date that new rates are effective. This is not another mechanism passed through to customers, but it allows Duncan to absorb rising natural gas costs in the short-term.

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[15] Zivan Surebuttal at 4:21-26.

[16] Id. at 5:1-6.

[17] Id. at 5:9-16.

[18] Id. at 4:9-19.

When those costs are paid for by customers through the adjustor or a surcharge, the line of credit can then be reimbursed.[19]

The mechanics of how the line of credit would work is fairly straightforward. For example, if the under-collected bank balance was $30,000 at the time new rates went into effect, but the under-collected bank balance subsequently grows to $55,000, then Duncan is allowed to borrow up to $25,000 to "fund" the increase in the under-collected PGA bank balance. If the under-collected balance then shrinks to $40,000, due to the implementation of a surcharge for example, then Duncan is allowed to borrow $10,000 – and $15,000 is then "repaid" to the line of credit.[20] This line of credit gives Duncan an effective method to fund increases in the under-collected PGA bank balance, and it frees up other revenues to pay for other expenses while helping to keep the Company in a financially stable position. The line of credit allows Duncan to absorb the hit of rising gas costs. What Staff is proposing is a reasonable yet innovative means to address Duncan's cash-flow concern.

VI. THE PGA SHOULD BE MODIFIED ONLY TO MAKE CUSTOMER BILLS EASIER TO UNDERSTAND, BUT NOT TO INCREASE RATE VOLATILITY

Staff proposes zeroing out the base cost of gas and placing the entire cost of gas into the PGA. Staff believes customers will then be better able to track and understand how changing natural gas costs affects their bills.[21] But to ensure that the actual cost of gas is tracked through the PGA, the $0.10 band in existence for the PGA must reference against the previous 12 months total cost of gas versus just the previous 12 months adjustor rate, for the first 12 months following a decision.[22] In the thirteenth month, the $0.10 band must then reference against the adjustor rate for the previous 12 months, since the adjustor rate will include the entire cost of gas for over a year. Duncan appears to support this recommendation.

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[19] Tr. at 154:12 – 155:18.

[20] Tr. at 141:4 – 142:11; See also Zivan Surebuttal at 6:20 – 7:23.

[21] See Direct Testimony of Steve Irvine, Exhibit S-5, at 2:9 – 3:8.

[22] Id. at 6:3-8.

Staff does not agree with Duncan that the $0.10 bandwidth for the PGA should apply on a monthly basis to allow for up to $0.10 swings in the adjustor rate each month. Duncan's proposal would allow for far more volatility in the adjustor rate than Staff is comfortable recommending. Staff acknowledges that sending price signals is an important factor, but so is gradualism and overall rate stability for customers. Staff's recommendation to give Duncan a $70,000 line of credit also lessens the need to change the adjustor rate calculation to Duncan's more drastic method.[23] It is a remote chance, if not impossible, that a the present average bandwidth would ever produce such volatile swings. Given that a $0.45 per therm surcharge was just approved for Duncan and given that natural gas prices continue to increase significantly, Staff believes any further changes should not result in any further volatility or sudden price spikes in the overall rates customers pay. Consequently, Staff believes maintaining the practice of operating the 10 cent bandwidth in such a way that the next month's PGA rate can be no more than 10 cents different from any rate in the previous 12 months, as is the current methodology, rather than allowing a 10 cent change from any month to the next lessens the burden to customers.[24]

Staff believes its recommendations on the PGA increases understandability in customer bills over the long-term, while promoting gradualism and stability in customer bills. To the extent that Staff's proposed changes may lead to some short-term confusion, Staff recommends a customer education effort, as described in its testimony.[25] Furthermore, Staff recommends, as it has in other cases involving adjustors, that a Duncan officer certify, under oath in an affidavit, that the monthly adjustor reports are true and accurate, to best ensure the veracity of such reports.[26]

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[23] Surebuttal Testimony of Steve Irvine, Exhibit S-6, at 2:16-22.

[24] Irvine Surebuttal at 4:10-24.

[25] See Irvine Direct at 4:21 – 5:6.

[26] Id. at 7:17-22.

VII. STAFF'S RATE DESIGN MITIGATES THE IMPACT OF THE RATE INCREASE TO ALL CLASS OF CUSTOMERS

There are many ways to compose a reasonable rate design. But Staff believes that Duncan's proposed rate design will severely impact residential ratepayers, especially during the winter months when residential customers use the most natural gas. Certainly, the impacts to irrigation customers cannot be ignored and Staff has not ignored the potential impacts to irrigation customers. By designing separate commodity rates for each customer class, while also designing uniform year-round commodity rates (versus separate summer and winter rates), Staff's rate design does not impact irrigation customers much differently than under Duncan's proposal. At the same time, Staff's recommended rate design avoids the severe impacts to residential customers during the high-use winter months.

Staff and Duncan are in agreement about the monthly minimum charges. Where Staff and the Company diverge is with regards to the commodity rate. Surebuttal Schedule SPI-4, attached to Steve Irvine's Surebuttal Testimony, is instructive when comparing Duncan's proposal to Staff's. What must be kept in mind looking at this schedule is that the base cost of gas is not zeroed out for the "Present Rates", but it has been zeroed out in the "Proposed Rates" for both Duncan and Staff. This is why most of the proposed commodity rates are lower than the present commodity rates when, in fact, customers will incur an overall rate increase.

Under Duncan's proposal, residential customers will be facing a commodity rate of $0.7300 per therm. This will mean residential customers will face a significant increase to their winter gas rates, when the cost of gas is factored back in. Staff does not think this is the most prudent way to design rates.[27] Rather, Staff proposes a uniform year-round commodity rate for each customer class, which lessens the impact to residential customers during the high-use winter months.

Duncan argues that combining summer and winter rates, as Staff proposes, will greatly impact irrigation customers to the extent that some will opt to switch to electric from gas for pumping. Most of Duncan's irrigation customers fall within the 250 to 425 or second customer

[27] Irvine Surebuttal at 3:8-17.

class. But Staff's commodity rates for these customers is not that different from what Duncan proposes for that class in the summer – $0.26000 per therm for irrigation customers in the summer under Duncan's proposal, versus $0.28480 per therm under Staff's proposal. This is because Staff recommended that each customer class have a separate but uniform year-round commodity rate. The cost of service study as amended by Staff justifies separate commodity rates per customer class, and that in this case, it is prudent to design separate commodity rates for each class.[28] This relieves the burden on irrigation customers. So, Staff's rate design distributes the burden on both irrigation and residential customers better than Duncan's proposal that hits residential customers hard during the high-use-winter months.

Staff's proposed rate design, as amended in its Surebuttal Testimony, achieves relatively equal sharing of new costs while moderating the impacts as much as possible. Staff also factors in affordability, stability and gradualism to its design. Based on all of the relevant factors, Staff believes separate commodity rates per customer class, but uniform year-round commodity rates for each class, and in this case, best balances the respective interests and produces a reasonable rate design equitable to all customer classes and types.

VII. CONCLUSION

Staff recommends approval of the following items because they are in the public interest:

- Approval of an equity improvement plan due to Duncan's negative equity ratio in its capital structure, which is hurting Duncan's ability to achieve any financing other than cash advances from DVEC.
- Approval of only $330,484 in long-term debt, rather than the $600,000 Duncan requests. Staff further recommends that $171,516 be treated as an equity infusion rather than long-term debt, because that amount was used to fund operating expenses. Staff does not recommend approval of $98,000 not yet advanced from DVEC. The interest rate for the $330,484 should be equal to that of the 270-Day-Fixed-Rate Note, which was at 2.725 percent on September 2, 2005.
- Approval of a $70,000 line of credit, to help Duncan deal with the rising costs of natural gas, and to address any increase in the under-collected bank balance from the date that new rates are effective.
- Approval of moving the entire cost of gas into the PGA, and zeroing out the base cost of gas. Also, Staff recommends a customer education campaign to explain

[28] Irvine Surebuttal at 4:10-22.

the change and that the monthly adjustor reports are certified, under oath per an affidavit, by an Officer in Duncan.

- Approval of Staff's rate design, including separate, but uniform year-round commodity rates for all three customer classes.

Staff does not believe that granted further five percent rate increases in 2006 and 2007 is warranted or supported by the evidence in this case.

RESPECTFULLY SUBMITTED this 24th day of January 2006.

Jason D. Gellman, Attorney
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007
(602) 542-3402

The original and thirteen (13) copies of the foregoing were filed this 24th day of January 2006 with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing were mailed this 24th day of January 2006 to:

Mike Grant, Esq.
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, Arizona 85016-9225

John Wallace
GCSECA
120 North 44th Street, Suite 100
Phoenix, Arizona 85034

Deborah Amaral